Montana Department of Revenue

Dan Bucks
Director

Brian Schweitzer
Governor

EXHIBIT 7
DATE 3-25-09
HB 658

Date March 19, 2009

To Ed Caplis,
Director Tax Policy and Research

From Mary Craigle,
Tax Policy Analyst

Subject Mill Growth and Property Tax Revenue in the Bill Draft requested by the Joint Select Committee on Property Reappraisal

During the Tuesday, March 17th meeting of the Joint Select Committee on Property Reappraisal there was discussion about the Department analysis of the committee bill draft for mitigation of property reappraisal. There was concern expressed about the projected growth in overall property tax revenue under the committee bill, specifically the department projection that there would be $1,355,422,749 overall property tax revenue by 2012.

After a detailed review of our computer modeling, the variables, assumptions and coding that underlie this model, I would confirm that the department analysis is indeed accurate and the projection of $1,355,422,749 is an appropriate depiction of the impact of the committee bill on property tax revenue in Montana.

The department's analysis is based upon local mills that are subject to Section 15-10-420, MCA and the state mills staying constant. The table below illustrates the factors involved in this analysis, demonstrates how the change in average mills from each year of the analysis does not exceed half the rate of inflation projected by the Department of Revenue, and correlates these variables to our property tax revenue projection contained in the committee bill analysis.

Growth in Mill Levies Under Proposed Law					
			Tax Year		
	2008	2009	2010	2011	2012
Average Mills	538.19	538.07	542.92	545.94	551.27
% Change in Mills		-0.02%	0.90%	0.56%	0.98%
DOR Calculated Half Inflation		0.98%	0.92%	0.73%	1.30%
Estimated Revenue for 1,392 Taxing Jurisdictions	1,141,535,793	1,192,187,629	1,249,765,400	1,301,921,059	1,355,422,749

Local mills for each levy district were calculated by growing the prior year's revenue by half the rate of inflation (based upon projections from Global Insight) and then dividing the current year's tax base into the adjusted revenue to get the new mill levy.

The SAS computer program code below illustrates how the program calculated the Section 15-10-420, MCA, growth for local mills for TY2009:

```
**mills 09*;  adjcllocaltaxes08=cllocaltaxes08*1.009833;
localmills09=adjcllocaltaxes08/cllevydtv09*1000;
run;
```

This local levy calculation is made 1,392 times in the program model, corresponding with all of the local levy districts. The local mill levy calculated by this programming is applied to the taxable value of properties within each levy district to calculate the taxes for each year. For each year in the analysis the prior years taxes was grown by half the rate of inflation calculated by the Department. Thus, the mills in the table above represent the average of the 1,392 separate levies plus the statewide mills.

Keeping the state mills constant is another factor that caused overall property tax revenue to grow at a level that is higher than was expected. The state mills were held constant in the department analysis in order to provide additional revenue for the circuit breaker model and the extended property tax assistance programs that are an integral part of the committee bill.

In January, the Legislative Fiscal Division (LFD) indicated that while the state mills are subject to Section15-10-420, MCA, state mills would not necessarily have to be decreased if reappraisal was not mitigated. This was caused by two factors: phase-in and growth of revenue by half the rate of inflation. Under the Joint Select Committee's bill there is enough mitigation that state mills do not have be reduced because of the increased value. The table above illustrates that Section 15-10-420, MCA does limit the growth of mills and the resulting property tax revenue to less than half the rate of inflation used by the Department, but not to the extent that the committee anticipated.

I hope that this memo serves to clarify and confirm the accuracy of the department analysis and the data presented to the committee.

March 3, 2009

Select Committee on Reappraisal:

The Select Committee has expressed an interest in maintaining a "revenue neutral" position regarding the cyclical reappraisal of property. There are potentially two (2) definitions of "revenue neutral"[i] that have been discussed by committee members. The selection of a definition for "revenue neutral" potentially sets the foundation for the mitigation policy decisions to come. Further, those mitigation policy decisions occur in the context of the historic and universal tension between market value taxation and the ability to pay of property tax owners. That context is described here as well.

Defining Revenue Neutrality:

Revenue Neutral Definition #1—No Tax Increase for Government, No Tax Shifts. The total statewide property tax liability of each of the three (3) classes of property subject to cyclical reappraisal will not change following the 2009-cyclical reappraisal of properties—and the total property tax liability of each of the two (2) subclasses within Class 4 will not change either. This definition recognizes that cyclical reappraisal could cause changes in property tax liability to individual properties within each of the reappraisal classes of property, but not between the classes. The amount and share of property tax liability for each class and sub-class will not change. Since the other classes are not subject to reappraisal and each of the reappraised classes are being kept revenue neutral, there will also be no increase to state, local or school district property tax revenue to fund government services resulting from property reappraisal. So, under definition # 1, each reappraised class and subclass is held revenue neutral, total property taxes for government services are held revenue neutral, and there is no shift of liability among any of the classes—that is the "pie pieces" remain the same size as before, just as the total pie remains the same size as well [reference to pie-chart analysis provided to Select Committee].

> Historical and Policy Note: Definition # 1 is the historic goal that Legislatures and Administrations have sought to achieve in nearly all of the reappraisal cycles. It is also that goal that the current Administration advocated to the Revenue and Transportation Interim Committee throughout 2007-08.

Revenue Neutral Definition #2—No Tax Increase for Government. The total statewide property tax liability for all taxable properties will not change as a result of the cyclical reappraisal of Classes 3, 4 and 10. This definition recognizes that changes in the proportion of property tax liability paid by any class of property will be changed as a result of the cyclical reappraisal but the effect on total statewide property tax revenue for all classes of property will be neutral. Thus, the total tax revenue "pie" stays the same size but the shares of property taxes—the "pie pieces" may shift and change [reference to pie-chart analysis provided to Select Committee].

Taxation by Value Tempered by Ability to Pay

The historic commitment of the Legislature and successive Administrations to a "no tax shifting due to reappraisal" position is actually a subset of a larger universal discussion—spanning not just decades but likely centuries and taxing jurisdictions far and wide—of the relationship between market value taxation and ability to pay. The most common policy issues in property taxation arise out of the tension or conflicts between taxation by market value and the ability to pay of the property owners. Property values often change in ways that are contrary to the ability to pay of its owners. As a result, legislative bodies frequently seek to mediate the tensions between market value taxation and ability to pay in a variety of ways as illustrated in these examples:

1. Agricultural land and forest land are not valued by market value, but in terms of their productivity—what the land can earn for its owners. Productivity value is almost always lower—much lower—than market value because it takes out of consideration the market demand for the land for uses other than agriculture and forestry. Productivity value links the taxable value of the land to the earnings from that land of its owners—to their ability to pay.
2. For commercial property, the increasing use of the income method of valuation is another means of harmonizing property values of the property to the earnings from that property of its owners—again to their ability to pay.
3. Net and gross proceeds of mines is based upon the sales proceeds earned from mining which is a reflection of the income potential of the property.
4. Similarly, elements of ability to pay taxation are included in centrally assessed valuation through the use of the income method as one indicator of value. Indeed, we began to see in 2008 some easing of values due to downward trend in earnings reflected through the income indicator.

At this point, it should be noted that for agricultural, forest, commercial and centrally assessed property, the linkage between valuation and ability to pay of the property owners has evolved into systematic methods of property taxation. Similar methods of tempering the relationship between market value and ability to pay are attempted in well-intentioned ways for other classes of property, especially residential property, but not always in systematic or even entirely successful ways. These methods are often dependent on periodic legislative intervention instead of being built automatically into the property tax system. Examples of these less systematic methods of tempering market value to reflect ability to pay—with one exception—follow below.

5. Market values that rise much faster than the income or business profits of property owners have led to the use of the method of "phasing-in" increasing values over a period of time in an effort to allow income or earnings to catch up to the change in market values. Phase-in seeks to synchronize property taxes in relation to income over time.
6. Property classification systems with varying tax rates are efforts, in part, to adjust market value taxation to perceived differences in the ability to pay of the owners of different types of properties. Businesses that are viewed as having greater options of shifting their taxes to customers or suppliers—i.e. having greater ability to pay—may be assigned higher tax rates by legislatures. Homeowners who cannot readily earn income from their properties or shift the tax burden to other property owners may be assigned lower rates. Small business properties may similar be treated in favorable terms because of the inability to shift the impact of the tax to other parties. (There may be other factors in classification than these, such as a desire to provide incentives for certain activities or to compensate local governments for high services costs associated

with concentrated industrial facilities—but ability to pay is one factor in classification systems.)

7. The tension between ability to pay and market value taxation create special issues within residential property taxation. Residential property taxes are typically regressive—the lower the income of a households the higher the percentage of income that households must pay in relation to property taxes. Because of the regressivity of residential property taxes, legislatures not only provide lower class rates for such properties, but also structure homestead exemptions or apply income-based reductions—circuit breakers—to harmonize property taxes on homes with the ability to pay of the owners.
8. In Montana, circuit breakers are used in a limited way through the Elderly Homeowner and Renter Credit, the Property Tax Assistance Program and the Extended Property Tax Assistance Program. Other states use circuit breakers in more universal way. Broad-based circuit breakers are the only means of systematically harmonizing market value taxation with the ability to pay of home dwellers.

In summary, the tension between market value taxation and ability to pay is a common theme that runs through property tax policy making. It is not unique to Montana. However, that understanding that tension and dealing with it openly and explicitly can be helpful to resolving issues in property taxation.

Background Information

Properties subject to cyclical reappraisal are Class 3 agricultural land; Class 4 residential and commercial land and improvements; and Class 10 forest land. All other classes of property are appraised annually.

Property tax revenue[ii] paid to the state and local governments as well as to school districts in Montana totaled $1.15 billion in tax year 2008. Of that total, the property taxes paid by properties subject to cyclical reappraisal are:

Class 3 agricultural land	$ 68.5 million (6.0% of the total)
Class 4 commercial land and improvements	$173.3 million (15.1% of the total)
Class 4 residential land and improvements	$557.9 million (48.5% of the total)
Class 10 forest land	$ 3.4 million (0.3% of the total)
Total paid by cyclical reappraisal property	$803.1 million (69.9% of the total)

Notes:

[i] Revenue neutral does not include any statutorily allowable growth in local budgets per 15-10-420, MCA. Revenue neutrality is based on total property tax liability from property tax year 2008.

[ii] Biennial Report, Montana Department of Revenue July 1, 2006 to June 30, 2008, amended page 129. Property tax revenue only includes revenues generated as a result of a mill levy calculation and does not include levies for special improvement districts (SID) or fees.

Table 1

Change in Value by Class By Counties - January 1, 2002 - July 1, 2008

County	Class 4 Residential % Increase	Class 4 Commercial % Increase	Class 3 Agricultural % Increase	Class 10 Forestland % Increase
Beaverhead	57%	43%	-2%	37%
Big Horn	41%	45%	3%	-59%
Blaine	38%	32%	53%	330%
Broadwater	61%	55%	52%	43%
Carbon	52%	29%	11%	-37%
Carter	37%	41%	30%	-42%
Cascade	40%	19%	19%	38%
Chouteau	42%	36%	4%	193%
Custer	55%	25%	56%	-15%
Daniels	25%	32%	43%	0%
Dawson	79%	60%	41%	0%
Deer Lodge	49%	41%	24%	11%
Fallon	54%	59%	67%	-78%
Fergus	52%	43%	21%	125%
Flathead	73%	47%	-20%	40%
Gallatin	51%	43%	31%	-39%
Garfield	77%	19%	40%	-100%
Glacier	33%	50%	33%	39%
Golden Valley	38%	7%	26%	88%
Granite	54%	20%	3%	-4%
Hill	41%	37%	32%	200%
Jefferson	50%	57%	30%	120%
Judith Basin	44%	53%	15%	74%
Lake	74%	49%	18%	59%
Lewis And Clark	62%	46%	29%	96%
Liberty	22%	40%	17%	0%
Lincoln	36%	24%	-31%	88%
Madison	37%	35%	23%	23%
McCone	54%	8%	51%	0%
Meagher	48%	29%	23%	28%
Mineral	59%	37%	-44%	84%